Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:[redacted]:TL-N-3945-99
[redacted]

date:

to: Chief, Examination Division, [redacted] District
Attn: [redacted]

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted] - Interest Accrual

This memorandum is in response to your request for advice regarding whether [redacted] may accrue interest related to proposed audit adjustments at the time [redacted] executes a Form 5701 Notice of Proposed Audit Adjustment as "Agreed". This issue is being coordinated with Joyce Albro in our National Office. The advice in this memorandum is subject to post-review in the National Office, which we will expedite. If you have any questions, please call the undersigned at [redacted], voice mail box #[redacted].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Issue

Whether a taxpayer may begin accruing interest related to proposed audit adjustments at the time the taxpayer submits an "agreed" Form 5701 Notice of Proposed Adjustment to the examining revenue agent.

Proposed Conclusion

Submitting an "agreed" Form 5701 Notice of Proposed Adjustment to the examining revenue agent does not trigger a taxpayer's right to begin accruing interest on the proposed audit adjustment.

Facts

For the year ended [redacted] and its [redacted] deducted interest on the agreed portions of the [redacted] through [redacted] Federal tax liabilities based either on the execution of a waiver of restrictions on the assessment and collection of tax (Forms 870 or 870AD), and/or a deficiency calculation by [redacted] based on Forms 5701 (Notice of Proposed Adjustment) where [redacted] had checked the agreed box.[1] For the year ended December 31, [redacted] deducted interest on the agreed portions of the [redacted] through [redacted] Federal tax liabilities. For the year ended December 31, [redacted] deducted interest on the agreed portions of the [redacted] and [redacted] Federal tax liabilities. The interest deduction/accruals were made in each year's Tax Journal Voucher 20 (JV-20). The JV-20 spreadsheet reflected the total interest by origination year as of the end of the current tax year, adjusted for prior years accruals and corrections to arrive at the current years deduction.

As part of its calculation, [redacted] netted overassessment interest and over-accrual corrections against its deficiency interest calculations in arriving at the current year's Federal interest deduction per JV-20.

In [redacted], [redacted] accrued interest on the [redacted] estimated federal income tax deficiencies based on its calculation of agreed proposed adjustments reflected on the Forms 5701 as of [redacted] This occurred prior to issuance of the Revenue Agent's Report (RAR). To perform the calculation, [redacted] multiplied the net increase to taxable income reflected on the Forms 5701 by the statutory tax rate of 46%, and adjusted the results by adjustments to credits reflected on agreed Forms 5701. [redacted] did

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[1] Form 5701 Notice of Proposed Adjustment details a proposed audit adjustment and contains boxes which the taxpayer can check indicating it : 1) agreed; 2) disagreed; or 3) had additional information to submit with respect to the proposed adjustment.

not consider credit limitation changes or changes due to carrybacks in the computation.

The [redacted] JV-20 interest accrual was $[redacted] for [redacted] $[redacted] for [redacted] $[redacted] for [redacted] and $[redacted] for [redacted], for a total accrual in [redacted] of $[redacted]. *The RAR and 30-day letter for the* [redacted] *audit cycle were issued on* [redacted]. For each year, the tax computations schedule, reflected two columns of tax calculations. One column reflected the proposed deficiency/ overassessment based on the total issues proposed. The second column reflected the proposed deficiency/overassessment based on the agreed adjustments.

For the [redacted] tax year, [redacted] calculated the total accrued interest through [redacted] for the [redacted] audit cycle based on the agreed portion of the proposed tax deficiencies as reflected in the RAR issued on [redacted]. Based on this calculation, [redacted] accrued and deducted additional interest of $[redacted] for [redacted], $[redacted] for [redacted] and $[redacted] for [redacted] for a accrual in [redacted] of $[redacted] In addition, [redacted] determined it had over-accrued the interest on its calculation of the estimated proposed deficiency for [redacted] in [redacted] by $[redacted] [redacted] reduced its total [redacted] JV-20 interest accrual by the [redacted] over-accrual of $[redacted]

On [redacted] [redacted] filed a Form 1139 (Tentative Carry back) as a result of a net operating loss incurred in [redacted] which generated refunds of $[redacted] Also on that date, [redacted] executed a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency) agreeing to additional tax assessments of $[redacted] for [redacted] and $[redacted] for [redacted] *for a total additional tax of* $[redacted]. *The additional tax* assessments generated interest liabilities of $[redacted] for [redacted] and $[redacted] for [redacted]. The additional tax and interest totaled $[redacted] for [redacted] and $[redacted] for [redacted].

For the [redacted] tax year, [redacted] accrued and deducted additional interest of $[redacted] for [redacted]. In addition, [redacted] reduced its previous accruals for [redacted] by $[redacted] for a net amount at issue in [redacted] of $[redacted] [redacted] did not provide any supporting documentation or explanation of the [redacted] and [redacted] accrual adjustments even though requested numerous times to do so.

On [redacted] [redacted] and the [redacted] Appeals Office (Appeals) entered into an agreement resolving all issues, contested and uncontested, for the [redacted] audit cycle except for adjustments relating to the [redacted] [redacted] executed a Form 870-AD (Offer of Waiver on Restrictions on Assessment and Collection of Deficiency) for the agreed tax liabilities. Appeals issued a statutory notice of deficiency for the unresolved adjustments relating to [redacted]

Forms 870 were sent to [redacted] with the 30-day letter for both the total and agreed amounts proposed in the RAR for the [redacted] audit cycle. [redacted] did not execute a Form 870 or other binding agreement for any issues proposed upon the issuance of the 30-day letter or with the filing of its protest. Consequently, [redacted] retained its complete rights to protest all of the proposed adjustments until [redacted], when [redacted] executed the Form 870-AD with Appeals.

For prior audit cycles, namely [redacted] and [redacted] [redacted] did execute Forms 870 for the agreed portion of the proposed deficiencies upon the issuance of the RAR and 30-day letter . Beginning with the [redacted] audit cycle and forward, [redacted] refused to execute a Form 870 for the agreed portion of the proposed deficiencies prior to a final determination by Appeals.

Members of the [redacted] Tax Staff have stated one of the reasons for not executing a Form 870 is, that to do so, would require [redacted] to file amended state and local income tax returns upon the execution of the partial agreement and again upon a final determination by Appeals. Another reason was [redacted]s cash flow position was precarious due to [redacted] incurring net operating losses in [redacted] and [redacted]. As a result, [redacted] timed the executions of Forms 870 to coincide with the time refunds were due from the filing of the tentative carry back Forms 1139 and, applying the refunds in payment of the tax and interest generated by Forms 870.

DISCUSSION

Internal Revenue Code Section 461(f) provides that if the taxpayer contests an asserted liability and transfers money or other property to provide for the satisfaction of the asserted liability, and the contest exists after the time of transfer, and but for the fact the liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year) determined after application of subsection (h), then the deduction shall be allowed for the taxable year of the transfer.

Treas. Reg. Section 1.461-2(b)(1) provides that for purposes of I.R.C. § 461(f), "asserted liability" means an item with respect to which, but for the existence of any contest in respect to such item, a deduction would be allowable under an accrual method of accounting.

Treas. Reg. Section 1.461-2(b)(2) provides any contest which would prevent accrual of a liability under I.R.C. § 461(a) shall be considered a contest for satisfying the requirements of section 461(f). A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability.

[redacted]s position is the interest deductions at issue (accrued on the [redacted] estimated federal income tax deficiencies based on the Forms 5701 to which [redacted] indicated agreement) are allowable under Treas. Reg. 1.461-1(a)(2) since all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

I.R.C. § 163(a) allows a deduction for all interest paid or accrued within the taxable year on indebtedness. I.R.C. § 461(a) provides the general rule that the amount of any allowed deduction or credit shall be taken for the taxable year which is proper under the method of accounting used in computing taxable income.

Treasury Regulation § 1.461-1(a)(2) provides under an accrual method of accounting, a liability is incurred and generally taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Rev. Rul. 70-560, 1970-2 C.B. 38, holds that interest on a tax deficiency asserted against a taxpayer should be accrued and deducted in the year the liability for the deficiency is finally determined, whether or not the deficiency is contested. Further, if a deficiency is not contested and is agreed to when asserted, then interest on the deficiency should be accrued in that year.

[redacted]argues that checking the agreed box on the IRS administrative Forms 5701 for *certain issues, fixes the liability even though the audit has not been concluded*, the 30-day letter and RAR have not been issued, and it has not executed any agreement restricting its right to disagree and protest the agreed issues. [redacted]also argues that its method of calculating additional taxes due meets the reasonable accuracy requirement.

In addition, [redacted]further states that upon issuance of the 30-day letter and RAR on [redacted] it did not protest the majority of agreed adjustments further establishing the fact of liability.

When a taxpayer can accrue interest on proposed audit adjustments was addressed by the court in Phillips Petroleum Co. and Affiliated Subsidiaries v. Commissioner, T.C. Memo. 1991-257. In Phillips, the taxpayer argued even though it failed to execute Forms 5701 as agreed or execute Forms 870 with respect to certain adjustments, it should be allowed to accrue interest on all adjustments during the years at

issue which were not ultimately protested to the Appeals Office. The Phillips court disagreed stating:

> [t]he present issue presents a specific question within this area of law: whether petitioner's 'unprotested adjustments' were 'contingent and contested,' or whether its liabilities for these items were 'settled,' and their amounts could be 'determined with reasonable accuracy.' ... [w]e conclude that 'petitioner's "unprotested adjustments' were not sufficiently settled to allow petitioner to accrue attendant interest expense deductions on its 1975 through 1978 returns. The petitioner retained its complete rights to protest these adjustments up until the days that it signed the Forms 866 and 870-AD. A line must be drawn between settled and contested liabilities. We hold that the proposed adjustments were sufficiently challenged by petitioner's nonacquiescence to render them contested. There is nothing in this record to show that petitioner conceded any of respondent's proposed adjustments prior to the time the waivers were filed for the respective years. Id. at 260.

In the present case, [redacted] argues Phillips supports its interest accruals prior to the final resolution of the issue in Appeals and its execution of Forms 870-AD since, contrary to the petitioner in Phillips, [redacted] checked the agreed box on the Forms 5701. [redacted] states checking the agreed box on the Forms 5701 is sufficient to establish the issues were settled and otherwise meet the all events test. However, [redacted]s argument fails to recognize the Form 5701 is an administrative document presenting proposed adjustments to the taxpayer during the course of an examination, instead of accumulating and presenting them all at once in the RAR. While it is a useful tool for both the Service and taxpayer in controlling and tracking the status of issues for RAR and protest purposes, it is a non-binding document. The Phillips court correctly noted that prior to the Appeals resolution, the petitioner had not executed, or offered to execute, any written agreement or authorization permitting respondent to assess any part of the proposed income tax deficiencies (or interest thereon) for each of the four audit cycles involved. As a result, the petitioner retained its complete rights to protest these adjustments until the time it signed the Forms 866 and 870-AD.

The Forms 5701 on which [redacted] checked the agreed box do not permit the Service to assess any part of the income tax deficiencies (or interest thereon) prior to the date of resolution in Appeals. As did the petitioner in Phillips, [redacted] retained its complete rights to protest these adjustments until it signed the Form 870-AD.

The Service's position was also advanced in the recent Tax Court case of Exxon Corporation and Affiliated Companies v. Commissioner, T.C. Memo 1999-247, wherein respondent noted that returning an agreed Form 5701 would not have established a liability because "... the form contains no language consenting to assessment and collection." Respondent's Brief at fn. 2. The Exxon court held that the interest on the adjustments do not relate back and accrue ratably for each year from the returns' due dates. Exxon, at 257. Rather, the interest begins to run only after the disputes (regarding the proposed adjustments) have been settled. The Exxon court also noted the importance of reviewing all the facts and circumstances (including whether the taxpayer indicates agreements to the Forms 5701) to determine whether the disputed issues have been settled/agreed and held that the disputed items at issue were not "fixed and definite until the end of the audits when the Form 870 agreements were entered into without further protest or litigation by Exxon or when the assessments occurred ..." Exxon, at 257.

In a 1992 Field Service Advice, 1999 TNT 30-103, the Service also noted, although a taxpayer may accrue interest on the agreed portion of the proposed deficiency notwithstanding the Service's inability to assess the taxes, there must be something which prevents an unprotected adjustment. In determining the proposed adjustments had been settled (and thus the related interest accrual was proper) the Service noted the taxpayer had Signed Forms 906 (closing agreement) and had submitted stipulations of settled issues and stipulations of fact to the Tax Court. Specifically, the Service noted,

> "[i]n contrast with Phillips, this taxpayer has not reserved a right to protest the adjustments giving rise to the interest deductions. Rather, the underlying liabilities have been settled. Although a Form 870 has not been signed, there are three factors which establish taxpayer's concession of the liabilities and absence of a contest. Taxpayer signed Form 906 agreements, and two Stipulations of settled issues and a Stipulation of Facts were filed with the Tax Court. Because no substantive contingency remains with respect to the conceded liabilities, we believe that the agreements and stipulations which were filed with the court establish the liability with finality; the taxpayer may no longer protest those adjustments. Accordingly, a final determination under section 1313 has occurred and the interest is accruable under Rev. Rul. 70-560.

As the Tax Court did in the Phillips case, the FSA considered whether the taxpayer had conceded or preserved its rights to protest the proposed adjustments in determining whether the taxpayer met the requirements of Rev.Rul. 70-560 for accruing interest on asserted tax deficiencies.

Similarly in Technical Advice Memorandum (TAM) 8210019 dated November 27, 1981, the Service recognized the importance of an agreement between the taxpayer and

the Service as to the proposed adjustments to permit an interest accrual thereon. Even though the taxpayer had orally agreed to the adjustments the Service noted:

> Section 601.105(b)(4) of the Statement of Procedural Rules provides that in an agreed case, the agreement is evidenced by the execution of a Form 870 or another appropriate agreement form. The oral admission of tax liability is less than binding event that fixes the taxpayer's tax liability (for the purpose of accruing interest expense under sections 163(a) and 461(a) of the Code). It is true that an assessment is not necessary for accrual, but for accrual of interest to take place before assessment, there still must be an established liability, and the "all events test" must be met.

The Service concluded the taxpayer could not accrue and deduct the interest expense under section 163(a) of the Code, because all the events had not yet occurred which would determine the fact of the liability under section 1.461-1(a)(2) of the regulations.

[redacted] argues checking the agreed box on the Forms 5701 is more binding than an oral concession, and therefore it has met the all events test. However, just as in an oral agreement, [redacted] had retained its complete rights to protest these issues up until the day that it signed the Form 870-AD in [redacted]

In reviewing the United States' Motion for Judgment, the court in Volvo Cars of North America Inc., f/k/a Volvo North America Corporation, and Volvo GM Heavy Truck Corporation, f/k/a Volvo White Truck Corporation, 97-2 U.S.T.C. P50,705, noted a binding agreement with respect to a proposed adjustment was not absolutely necessary to allow an interest accrual where an agreement between the Service and the taxpayer had been reached and the execution of a binding agreement was merely an administrative act. In Volvo the taxpayer had reached an agreement with Appeals as to a final deficiency for its 1980 through 1983 tax years. The Service and taxpayer had agreed to the final deficiency amounts and a Form 870-AD had been prepared and mailed to the taxpayer in late December, 1990. The taxpayer did not sign and return the Form 870-AD until early January, 1991.

The Volvo court found the characterization of the compromise settlement as legally binding did not govern whether all the events necessary to establish the additional tax liability occurred in 1990. Instead, the proper test was whether all of the events that bear on the fact of the liability had occurred and the amount of the liability could have been determined with reasonable accuracy in 1990. Since the primary meetings between the IRS and Volvo had concluded in June 1990, and the tax calculations submitted and verbally agreed to between the parties in September and October 1990, the fact of Volvo's additional tax liability was established in 1990. Thus, the signing of the Forms

870-AD was just an administrative act. Accordingly, the court held Volvo could accrue the interest on the tax deficiencies in 1990. [2]

The facts in Volvo are distinguishable from Phillips and [redacted] in that all of the adjustments giving rise to the interest deductions at issue were protested, considered by Appeals, and resolved by an agreement in principle by both parties in September or October of 1990. There were no issues pending where the taxpayer preserved its rights to protest or which would change the amount of the liability. [redacted] was not factually in the same position as Volvo until [redacted] Consequently, under Volvo, [redacted] cannot accrue interest for the [redacted] audit cycle until final resolution in [redacted] by Appeals. If [redacted] wanted to accrue interest expense in [redacted] and [redacted] on the [redacted] tax deficiencies, it should have executed a Form 870 for the agreed adjustments and paid the tax, filed amended returns, or executed a binding agreement relinquishing its right to protest the adjustments.

Additionally, [redacted] could not determine the amount of interest due with reasonable accuracy until the examinations were completed and final deficiency determinations for each year were made.

The "all events" test requires that, in order for an accrual basis taxpayer to deduct an expense in a given year, not only must it establish the fact of liability, but it must also be able to determine the amount of the liability with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2). [redacted] could not determine the amount of interest on its income tax deficiencies with reasonable accuracy until the amount of their deficiency was determined.

[redacted]s numerous formal and informal refund claims made the existence or amount of any deficiency uncertain. The amount of any potential deficiency could not be determined with any accuracy before the examinations were completed and final deficiency determinations for every taxable year were made. Interest could not be calculated with reasonable accuracy until the amount of the liability to which the interest applied could be determined.

Conclusion

There must have been a binding agreement between the taxpayer and the Service which establishes a liability with finality and the taxpayer may no longer be able to protest the adjustments in order for the taxpayer to be able to deduct interest relating to income tax deficiencies. Checking the agreed box on Forms 5701 for some of the proposed

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[2] Contact between this office and the Department of Justice indicate an appeal of the Volvo case is pending.

adjustments is not a binding agreement that fixes [redacted]'s tax liability for purposes of accruing interest expense under I.R.C. §§ 163(a) and 461(a). Additionally, the amount of any potential deficiency could not be determined with any accuracy before the examinations were completed and final deficiency determinations for every taxable year were made.

Consequently, the premature interest accruals of $[redacted] in [redacted] $[redacted] in [redacted] and $[redacted] in [redacted] for the [redacted] audit cycle were not allowable until the Appeals resolution in [redacted]

Should you have any questions concerning this matter, please contact the undersigned attorney at [redacted]

[redacted]
District Counsel

By: _____
[redacted]
Attorney